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883230—63——1

In the Supreme Court of the United States

OCTOBER TERM, 1962

No. 945

JACK AND CELIA FARBER, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (Pet. 1a–28a) are reported at 36 T.C. 1142. The opinion of the Court of Appeals (Pet. 31a–43a) is reported at 312 F. 2d 729.

JURISDICTION

The judgment of the Court of Appeals was entered on January 11, 1963. (Pet. 44a.) The petition for a writ of certiorari was filed on March 20, 1963. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254(1).

QUESTIONS PRESENTED

1. Whether Section 117(m) of the Internal Revenue Code of 1939, which taxes gain on the sale or exchange of stock in a collapsible corporation as ordinary income, is inapplicable to sales of stock which take place prior to the time that construction of the corporation's property is completed.

2. Whether, in cases where stock in a collapsible corporation is sold prior to the completion of construction, the computation of gain attributable to the corporation's property for the purpose of applying the limitation in Section 117(m)(3)(B) includes all gain attributable to the partially constructed property, and not merely the portion added by the physical improvements.

3. Whether Section 117(m) is inapplicable in circumstances where a stockholder would have been entitled to capital-gains treatment if he had owned the collapsible corporation's property individually instead of through a corporation.

STATUTE INVOLVED

Section 117(m) of the Internal Revenue Code of 1939 is printed in the Appendix, *infra*, pp. 10–12.

STATEMENT

The essential facts are summarized in the opinion of the Court of Appeals (Pet. 32a–35a) as follows:

Taxpayer Jack Farber, who was engaged in various real estate activities, formed Eagle Mount Corporation in 1950 and was its sole stockholder. In May, 1952, Eagle Mount acquired an unimproved tract of

land on Long Island. The corporation paid to the seller $7,202.46 advanced by taxpayer and delivered its note for $35,500 secured by a purchase money mortgage. Eagle Mount (or taxpayer on its behalf) commenced the intended development program. An architect retained to revise the map of the tract to meet a local zoning ordinance was paid $300 on account. Application was made to local authorities for permits to erect 29 houses and for necessary water and sewer arrangements; this involved the payment of $3,581.50 as fees for building permits, the filing of a bond ($546 premium) for improvements, a $6,200 deposit for plumbing materials and a $1,334 advance for utility connections. Eagle Mount also filed application with the Federal Housing Administration for conditional loan insurance commitments, paying filing fees of $1,305. All of these payments, totaling $13,266.50, were advanced by taxpayer. None of these activities, however, had resulted in any physical changes in the tract at the time that taxpayer sold his stock in Eagle Mount.

On November 18, 1952, taxpayer entered into an agreement with two other builders for the further development of the project. The agreement provided, among other things, that a newly-formed corporation, Eagle Garden Homes, Inc., would purchase all of taxpayer's stock in Eagle Mount for $160,000. Taxpayer was given a note for $150,000, and it was provided that he would hold his stock in Eagle Mount as collateral security. Eagle Garden proceeded with the construction of 81 one-family houses on Eagle

Mount land. In 1953, taxpayer received $77,500 from Eagle Garden and in 1954, $82,500. The Commissioner of Internal Revenue determined that taxpayer had realized gain on the sale of his stock which was taxable as ordinary income under Section 117(m) of the Internal Revenue Code of 1939. The Tax Court sustained that determination, with one dissent, and the Court of Appeals affirmed the decision of the Tax Court.

ARGUMENT

The decision below is correct, and there is no conflict or any other reason for further review.

1. Section 117(m) of the 1939 Code, Appendix, *infra*, pp. 10–12, provides that gain from the sale or exchange of stock of a "collapsible corporation" is to be taxed as ordinary income rather than capital gain. A "collapsible corporation" is defined as one "formed or availed of principally for the manufacture, construction, or production of property * * * with a view to—(i) the sale or exchange of stock by its shareholders * * * prior to the realization by the corporation * * * of a substantial part of the net income to be derived from such property, and (ii) the realization by such shareholders of gain attributable to such property." For the purposes of this definition, Section 117(m)(2)(B) provides that a corporation shall be deemed to have manufactured, constructed or produced property if it engaged in the manufacture, construction or production of such property "to any extent."

Both courts below have held that the activities of Eagle Mount in relation to the building tract, *eg.*, making payments for utility connections and plumbing materials, obtaining building permits, and filing loan applications, constituted construction "to any extent" within the meaning of the statute. This determination is consistent with prior decisions. *Abbott* v. *Commissioner*, 28 T.C. 795, affirmed, 258 F. 2d 537 (C.A. 3d), and *Payne* v. *Commissioner*, 30 T.C. 1044, affirmed, 268 F. 2d 617 (C.A. 5th). More importantly, it is in accord with the clear purpose of Congress to tax the additional values created by each of successive corporations engaged in the manufacture, construction or production of property.[1]

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[1] See H. Rep. No. 2319, 81st Cong., 2d Sess., p. 98 (1950-2 Cum. Bull. 380, 449-450), and S. Rep. No. 2375, 81st Cong., 2d Sess., p. 30 (1950-2 Cum. Bull. 483, 547), explaining why the statute was drawn to include a corporation which engaged in the manufacture, construction, or production of property "to any extent" (Section 115 (m) (2) (B) (i)) even though it neither began nor completed the process: "It will nonetheless be deemed to have manufactured, constructed or produced property in that its shareholders may realize gain with respect to the additional value added to the property by the manufacture, construction or production to the extent that it was carried out."

See also Section 39.117 (m)-1 (b) (6) of Treasury Regulations 118 (1939 Code):

"A corporation shall be deemed to have manufactured, constructed, produced, or purchased property if it (i) engaged in the manufacture, construction, or production of property to any extent * * *. Thus, under subdivision (i) of this subparagraph, for example, a corporation need not have originated nor have completed the manufacture, construction, or production of the property."

Taxpayer makes no real contention that Eagle Mount did not engage in construction "to any extent." Rather, it is his argument that Section 117(m) should not be applicable except where the construction is completed, or at least has advanced to the point where the property is able to produce net income to the corporation. Presumably it is taxpayer's position that until the individual dwelling houses were in such condition that they might be rented, Eagle Mount could not be a "collapsible corporation." The limitation contended for by taxpayer is not only contrary to the case law but would provide an easy escape from Section 117(m) by the use of multiple corporations. This is precisely the type of maneuver anticipated by Congress, which it barred by including in the definition of collapsible corporations those which engaged in manufacturing, construction, or production of property "to any extent."

2. The application of Section 117(m)(1) is expressly limited to gain recognized during a taxable year where "more than 70 per centum of such gain is attributable to the property * * * constructed". Section 117(m)(3)(B). A question of fact is presented in each case as to what percentage of the total gain is attributable to values added by the work performed by the taxpayer's corporation, and what portion is attributable to other sources. As the court below pointed out, other taxpayers "jousting with the clause" have attempted to show that more than 30 percent of their recognizable gain traceable to the property did not stem from the construction process. (Pet. 41a.) Taxpayer in this

case, where all of the gain clearly relates to the property constructed, advisedly makes no such claim. Instead, he seems to be contending that some part of the gain is attributable to work still to be done when he sold his stock, which was later performed by the second corporation, Eagle Garden.

But this argument flies in the face of the undisputed facts. Petitioner was paid $160,000 for his stock presumably because the work already performed by Eagle Mount was then worth that much. Doubtless, a large part of the price reflected the value of a going project from which the parties expected generous profits, rather than physical improvements to the land. But that element of value is equally attributable to services performed by Eagle Mount with respect to the property. Nothing in the statute suggests that the gain must be related to tangible improvements only. The Regulations make it clear that the contrary is true.

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[*] Section 39.117(m)-1(c)(3) of Treasury Regulations 118 (1939 Code) provides, in part, as follows:

* * * * * *

"(iii) Gain may be attributable to the property referred to in section 117(m)(2)(A) even though such gain is represented by an appreciation in the value of property other than that manufactured, constructed, produced, or purchased. Where, for example, a corporation owns a tract of land and the development of one-half of the tract increases the value of the other half, the gain attributable to the developed half of the tract includes the increase in the value of the other half."

* * * * * *

See also *Short* v. *Commissioner*, 302 F. 2d 120 (C.A. 4th); *Glickman* v. *Commissioner*, 256 F. 2d 108 (C.A. 2d).

3. The final argument of taxpayer is that Section 117(m) has no application to cases where a taxpayer would have been entitled to capital gain treatment if he had held title to property in his own name rather than through a corporation. Taxpayer concedes that this issue was not raised by him in the Court of Appeals (Pet. 13). Accordingly, there appears to be no reason why this Court should depart from its policy of refusing to review issues abandoned or not pressed below. *Lawn* v. *United States*, 355 U.S. 339, 362, fn. 16; *Duignan* v. *United States*, 274 U.S. 195, 200.

In an effort to justify revival of the issue here, taxpayer states that it would have been futile to press his argument in the court of appeals for the reason that the court had previously rejected it in *Braunstein* v. *Commissioner*, 305 F. 2d 949 (C.A. 2d) (Pet. 13). Even if this excused taxpayer's abandonment of the issue below—and, in our view, it does not—we think that taxpayer is in error. The *Braunstein* decision conflicted with *United States* v. *Ivey*, 294 F. 2d 799 (C.A. 5th), and this Court granted certiorari to resolve that conflict. The issue before this Court in *Braunstein* v. *Commissioner*, No. 476 (scheduled for argument this month) is whether Section 117(m) applies where the shareholders would have been entitled to capital gains treatment had they conducted the enterprise in their individual capacities rather than in the form of a corporation.

Understandably, taxpayer does not phrase the issue that way. If he had himself "conducted the enter-

prise" as an individual, constructing and selling 81 individual dwelling houses one at a time, this would have presented a classical example of holding property primarily for sale to customers in the ordinary course of his trade or business, which would preclude capital gain treatment under the express terms of Section 117(a)(1)(A) of the 1939 Code. Taking the issue as taxpayer phrases it, his case is not advanced even if the operation of Section 117(m) depended upon a tax liability parallel between the activities of the shareholders in a corporation and the activities of the shareholders in their individual capacities.

CONCLUSION

For the reasons stated, the petition for certiorari should be denied.

Respectfully submitted.

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APRIL 1963.

APPENDIX

Internal Revenue Code of 1939:

SEC. 117. CAPITAL GAINS AND LOSSES.

* * * * *

[(m) [as added by Sec. 212(a) of the Revenue Act of 1950, c. 994, 64 Stat. 906, and as amended by Sec. 326(a) and (b) of the Revenue Act of 1951, c. 521, 65 Stat. 452] *Collapsible Corporations.*—

(1) *Treatment of gain to shareholders.*—Gain from the sale or exchange (whether in liquidation or otherwise) of stock of a collapsible corporation, to the extent that it would be considered (but for the provisions of this subsection) as gain from the sale or exchange of a capital asset held for more than 6 months, shall, except as provided in paragraph (3), be considered as gain from the sale or exchange of property which is not a capital asset.

(2) *Definitions.*—

(A) For the purposes of this subsection, the term "collapsible corporation" means a corporation formed or availed of principally for the manufacture, construction, or production of property, for the purchase of property which (in the hands of the corporation) is property described in subsection (a)(1)(A), or for the holding of stock in a corporation so formed or availed of, with a view to—

(i) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, prior to the realization by the corporation manufacturing, constructing, producing, or purchasing the property of a substantial part of the net income to be derived from such property, and

(ii) the realization by such shareholders of gain attributable to such property.

(B) For the purposes of subparagraph (A), a corporation shall be deemed to have manufactured, constructed, produced, or purchased property, if—

(i) it engaged in the manufacture, construction, or production of such property to any extent,

(ii) it holds property having a basis determined, in whole or in part, by reference to the cost of such property in the hands of a person who manufactured, constructed, produced, or purchased the property, or

(iii) it holds property having a basis determined, in whole or in part, by reference to the cost of property manufactured, constructed, produced, or purchased by the corporation.

(3) *Limitations on application of subsection.*—In the case of gain realized by a shareholder upon his stock in a collapsible corporation—

(A) this subsection shall not apply unless, at any time after the commencement of the manufacture, construction, or production of the property, or at the time of the purchase of the property described in subsection (a)(1)(A) or at any time thereafter, such shareholder (i) owned (or was considered as owning) more than 10 per centum in value of the outstanding stock of the corporation, or (ii) owned stock which was considered as owned at such time by another shareholder who then owned (or was considered as owning) more than 10 per centum in value of the outstanding stock of the corporation;

(B) this subsection shall not apply to the gain recognized during a taxable year unless more than 70 per centum of such gain is attributable to the property so manufactured, constructed, produced, or purchased; and

(C) this subsection shall not apply to gain realized after the expiration of three years following the completion of such manufacture, construction, production, or purchase.

For purposes of subparagraphs (A), the ownership of stock shall be determined in accordance with the rules prescribed by paragraphs (1), (2), (3), (5), and (6) of section 503(a), except that, in addition to the persons prescribed by paragraph (2) of that section, the family of an individual shall include the spouses of that individual's brothers and sisters (whether by the whole or half blood) and the spouses of that individual's lineal descendants. (26 U.S.C. 1952 ed., Sec. 117.)

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